- A6450-2
8/14/87
...azine
...ate Finance

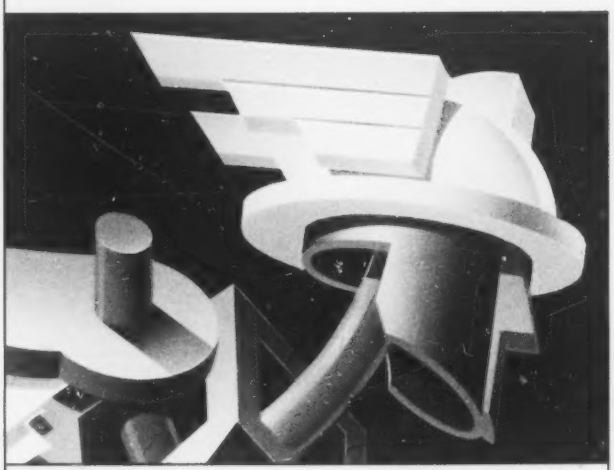
MORTGAGE BANKING

AUGUST 1987

S6219.SU
SRI ACQUISITIONS
CONGRESSIONAL INFORMATION
SERVICE
4520 EAST-WEST HGWY., STE. 800
BETHESDA, MD 20814

VOLUME 47 NO. 11
AUGUST 1987

MORTGAGE BANKING



ARTICLES

PAGE 8
COST OF SERVICING: THE ERODING RETURNS
Dr. Victor Cholewicki
This exclusive article details the cost of servicing loans in 1986. Net servicing expenses soared to $95 per loan which was a 34 percent increase above last year. Read all about why costs have skyrocketed and what reasons caused it.

PAGE 24
OUTCLASS THE COMPETITION WITH SERVICE DISTINCTION
Clifford D. Moore, III
Service quality is hard to define and difficult to measure so few mortgage banking firms have attempted to monitor it. But because consumers complain to branch offices instead of to middle or senior management the costs of low-income quality, including customer turnover, may not be evident to managment. Dissatisfied buyers will change suppliers rather than complain.

PAGE 41
CERTIFIED MORTGAGE BANKERS: THE WOMEN AT THE TOP
Several women CMBs share their insights on how the designation has furthered their careers in real estate finance and why more people should aspire to attain it.

PAGE 50
LASER: FLEET OF FOOT LOAN MANAGEMENT
Richard M. Leegant
LASER permits Fannie Mae to fund most loans within three to four days, rather than nine days. It captures loan information from commitment through delivery, payment applications and final liquidation modifying information along the way. Learn more about the future of LASER in this article.

PAGE 61
SOUND SERVICING PROGRAMS: THE MODERN CURE FOR DEFAULTS AND FORECLOSURES
L. Rick Butler
Audits of servicing departments across the nation reveal that most lenders have servicing programs that are obsolete or non-existent. This article explains how foreclosure is being used as an early collection tool rather than as the last alternative.

PAGE 73
NON-EARNING ASSETS: NEVER RISK THE UNKNOWN
Eric L. Stewart and E.S. Olrich
One of the greatest risks of managing non-earning assets is not having all the facts readily available. Then management gets caught with costly surprises because there is a lack of information to use to evaluate potential problem areas.

PAGE 83
PROACTIVE SERVICING MANAGEMENT PRODUCES THE PROFITS
Mary Bruce Batte
The ultimate of proactive servicing management is not only creating a buy/sell plan for servicing rights and making functions profitable but also evaluating and selecting loan production strategies and pricing.

PAGE 90
TEAMWORK: CHARTING A COURSE FOR SUCCESS
Gregory T. Barmore
Winning at mortgage lending is not unlike winning in yacht racing. The winner is the one with perfect execution and that requires top performance from each crew member, aimed at ensuring the team's success.

PAGE 97
MORTGAGE SERVICING SYSTEM: A CASE STUDY BY A MAJOR MORTGAGE LENDER
Douglas R. LaBoda
Learn how Travelers selected and implemented a mortgage servicing system in this article. Companies who are working to replace an old system should consider several fundamental points.

PAGE 103
BUSINESS BASICS COLLECTION TECHNIQUES: SURVIVING THE 1980s
Charles D. Bertrand
Morgage lenders may not be able to change economic conditions, but they can change the public's perception about the consequences of default. Lenders need to adopt a policy that calls for reasonable efforts to collect every deficiency.

DEPARTMENTS

ABOUT THE ISSUE	3
BUSINESS BASICS	103
PEOPLE	108
BOOKS	116
SECONDARY MORTGAGE MARKETS	119
MORTGAGE MARKET TRENDS	121
AD INDEX	130

Dr. Victor Cholewicki

COST OF SERVICING The Eroding Returns

A surge in mortgage loan prepayments, together with deepening delinquency and foreclosure problems, worsened by the Veterans Administration's (VA) increasing use of its no-bid option on foreclosed properties, wracked the servicing operation in 1986. Net servicing expenses soared to $95 per loan, a 34 percent increase above the prior year's figure. At the same time, firms saw a large portion of their investment in servicing rights wash away as the underlying loans were prepaid, requiring the accelerated expensing of the remaining unamortized portion of the purchase price. These massive cost increases, in the face of a moderate rise in income, resulted in a 40 percent plunge in net servicing income per loan and a drop in before tax profit margin for the servicing operation to an unprecedented 26 percent.

The stark rise in unit servicing costs was accompanied by a disappointingly small gain in servicing volume. At first glance it might have been anticipated that the 1986 flood of origination volume would result in significantly stronger portfolio growth than that of the prior year. However, even though mortgage bankers' 1986 single-family origination volume increased by 108 percent, as reported by the Department of Housing and Urban Development (and confirmed in the Mortgage Bankers Association survey), firms reporting in 1986 experienced only a 14 percent rate of growth of dollar volume serviced and a mere 3 percent increase in number of loans serviced (See Table 1). A full 41 percent of the 1986 sample reported a decline in number of loans serviced. One geographic region, the West, experienced an 11 percent drop in this figure.

Even taking into account the high refinance volume, which is estimated to have amounted to 40 percent of the dollar volume of all single-family loans closed in 1986, the portfolio growth figures are surprisingly small. In comparison, the 1985 survey showed an increase of 15 percent in dollar volume serviced while the number of loans serviced rose 7 percent. These magnitudes were achieved in a year in which mortgage bankers' single-family origination volume was barely more than half their 1986 level, but in which refinancings accounted for an estimated 15 percent of total single-family origination volume.

The somewhat slower than expected portfolio growth in 1986 was largely the result of an increase in the net sale of servicing rights by survey respondents in bulk form, in contrast to the large purchases of 1985. Firms sold servicing for a variety of reasons—to improve cash flow, pay off long-term debt, restructure their portfolios, etc. However, for many firms the motivation was to fund foreclosure losses and to strengthen their financial positions, as they faced an 81 percent increase in the dollar volume of real estate owned in 1986 compared with their 1985 level.

Servicing income

Servicing income rose to $180.53 per loan, a 6 percent increase compared with the 1985 figure of $170.80 (See Tables 2 and 3 with footnotes). This item has grown at a somewhat slower pace than the average loan size serviced during the past three years. Although servicing fees have kept pace with increases in the average size loan serviced, as servicing fee as a percent of dollar volume serviced remained virtually unchanged, large increases in net losses on foreclosures have resulted in a steady decline in servicing income as percent of dollar volume serviced. This figure fell to 44 basis points in 1986 compared with

ILLUSTRATION BY DAVID HENDERSON

the 47 basis points recorded in 1984.

Net losses on foreclosures have been steadily worsening during the past six years and show no sign of improvement in the near future (See Table 4). The 1986 figure of $10.49 per loan represents a 55 percent increase above the $6.77 level recorded the prior year. As recently as 1983 this item was $1.75. Much of the increase stems from expenses incurred on foreclosures on VA loans, with a major factor being the increased use by VA of its no-bid option. The no-bid option is currently being invoked in about 15 percent of all foreclosures on VA loans. The loss on a single no-bid VA foreclosure can run into tens of thousands of dollars. For firms whose portfolios consist of 30 percent or more of VA loans (dollar volume), the losses on foreclosure per loan serviced item was, on average, well in excess of $20.

The VA foreclosure problem is especially important to mortgage bankers, who service the majority of outstanding VA loans. The fact that 21 percent of the average firm's servicing portfolio consists of VA loans, and that there is no clear indication yet that the percentage of loans in long-term delinquency and foreclosure is subsiding, indicate that this negative income item cannot be expected to improve in the near term.

Servicing expenses

Net servicing expenses soared to $95.08 per loan in 1986, a full 34 percent higher than the $71.01 figure of the prior year (See Table 5). As a percent of the dollar volume of loans serviced, net servicing expenses reached 23 basis points, well above the 17 to 19 basis point range of the previous seven years. In addition, the amortization of the cost of purchased servicing, the balance of the gross expense item, nearly doubled on a per loan basis, reaching $39.46 per loan compared with the $23.88 figure recorded in 1985. Thus, gross servicing expenses increased to $134.54 per loan in 1986, a full 42 percent rise above the prior year's $94.89 figure.

Last year's burst of origination volume, with its large refinance component, brought a major inflow of new loans to firms' servicing portfolios, which was almost matched by the outflow from the portfolios. In effect, market forces were churning the portfolio. As a result, servicing staffs were swamped with accelerated demands for new loan set-up as well as the processing of payoff requests. In addition, the worsening delinquency and foreclosure problems caused a need for more staff in the collection and foreclosure, and for some, the real estate owned (REO) departments. Firms responded with an 8 percent increase in their number of loan administration personnel.

Despite the burgeoning demands on the staff, loan administration personnel expenses per loan increased only 12 percent last year, reaching $37.62 compared with the $33.58 figure of the prior year (See Table 6). This was only slightly higher than the percent increase in average loan size serviced, leaving personnel expenses as percent of dollar volume serviced virtually unchanged at 9 basis points. The direct loan administration compensation component increased to $31.25, a 15 percent increase above the prior year's figure. (There was a modest decline in the remaining personnel expense components). The increase in direct compensation per loan serviced was the result of an 11 percent rise in average loan administration personnel salaries to $16,885 and a 5 percent fall in the number of loans serviced per servicing employee to 549. These figures were $15,187 and 579, respectively, in 1985. The rise in personnel salaries, following a slight decline the previous year, was only partly the result of cost of living increases. Perhaps a more important factor was the fact that many of the new hires were in the higher salaried collections, foreclosure and REO departments. In some cases REO staff was remunerated on a commission basis, which added still more to personnel compensation expenditures.

The unusually high rate of turnover of the servicing portfolio had a major effect on the more efficient servicers, driving down considerably their number of loans serviced per servicing employee. Only 11 firms, or 9 percent of the sample, achieved the level of 700 or more loans serviced per employee in 1986. In 1985, 20 percent of the sample achieved this level of productivity while in 1984 the figure was 26 percent. Fifteen of the 20 firms whose number of loans serviced per employee exceeded 700 in the 1985 survey reported in the 1986 survey as well. In 1985 this group averaged 807 loans serviced per employee; this figure fell to 677 in 1986. Only six of the fifteen who attained the 700 level in 1985 reached that level in 1986. However, these firms were, for the most part, up among the leaders both years.

Occupancy

Occupancy expenses reached $4.58 per loan and $2,475 per servicing employee in 1986, increases of 25 percent and 21 percent, respectively, over the previous year's levels. (See Table 7). A major part of the increases in these items can be attributed to a more careful allocation by the 1986 survey respondents. The roughly 8 percent growth in loan administration staff, together with a slight decrease in the number of loans serviced per employee, accounted for some of the additional expenses, especially on a per loan basis. Also, some firms incurred substantial costs in this area through the restructuring of servicing operations and the consolidation of existing operations. For others the tem-

Dr. Victor Cholewicki is an economist for the Mortgage Bankers Association. He received his Ph.D. in economics from Brown University. Before joining MBA, Dr. Cholewicki served on the faculty at Boston University and at the Catholic University of America.

porary scaling down of the operation in the wake of a large servicing sale or transfer also added to costs on a per unit and per employee basis.

There appears to be a size threshold for achieving cost efficiencies in the occupancy component of the servicing operation. Smaller firms, those servicing less than $300 million have, on average, significantly higher occupancy expenses on both a per employee and a per loan serviced basis. These firms average $4,188 in occupancy expenses per servicing employee and $13.86 per loan. This compares with the $2,000 to $2,500 range per employee and $4 to $7 range per loan for larger firms. However, occupancy expenses do not appear to have a strictly inverse relationship to firm size. The lowest occupancy expense per employee figure was the $2,016 per employee figure recorded by the $1 to $2 billion size category, which was significantly below that of neighboring size categories.

The somewhat slower than expected portfolio growth in 1986 was largely the result of an increase in the net sale of servicing rights by survey respondents in bulk form, in contrast to the large purchases of 1985.

Electronic data processing

Electronic data processing expenses (EDP) per loan (Table 7) rose 35 percent to $9.05 per loan in 1986, while EDP expenses per servicing personnel increased 30 percent to $4,889. This was largely the result of the surge in mortgage loan prepayments and does not reflect a major increase in investment in automated systems. Heavy prepayment activity requires a well above average number of inquiries as to loan status and current principal balance. An unusually high number of inquiries is especially costly to firms using service bureaus, where servicers are billed on a per inquiry basis after their initial allotment has been exhausted. Unusually heavy usage is also a significant factor for those with in-house data processing systems. Also, services on which annual fees are paid add to unit costs when loans pay off in mid-year.

In examining the other direct expenses category it is useful to consider the enumerated items such as telephone and postage, and other supplies separately from the all other operating expense item. In the aggregate, the enumerated other direct expenses items reached $12.77 per loan, an 11 percent increase above the comparable 1985 figure. This was the result of the increased demands and workload caused by the heavy prepayment environment of 1986. However, the increased workload does not explain the 78 percent increase in all other operating expenses. This item reached $18.88 per loan in 1986 compared with the $10.62 figure of the prior year. The vast majority of this increase appears to be payoff expenses—the cost of paying off the balance of the month's interest to the investor on loans that prepay in the middle of the month. (Not all loans have this requirement.) These expenses were a major cost element in the servicing operation in 1986, in contrast to previous years when they were a relatively insignificant item. However, even though exceptionally large payoff expenses were incurred by servicing operations, there was at least a partial offset to the firm—the use by the treasury of the paid off principal balance for the remainder of the month. Relatively few firms credited their servicing operations with the value generated by having the free use of the paid off principal balance of prepaying loans. As a result, most firms with heavy pay off expenses will probably show higher profitability in their warehouse operation from the use of the prepaid principal balances in funding loan production and supporting credit lines.

Another, less important, part of the all other operating expenses item was the amortization of excess servicing fees. This was a significant expense in 1986 as many firms chose to take excess servicing fees in a declining interest rate environment and enter the capitalized value on their balance sheets. For the most part, this item was netted out of servicing fee income. However, a small portion was entered as operating expenses.

Provisions for loan losses rose a startling 144 percent for the average firm in 1986, reaching $12.19 per loan. Continuing increases in the longer period delinquency rates was the major cause of the increase. Many firms increased their funding of reserves in anticipation of a continuation or worsening of delinquency problems in the near term.

Purchased servicing

The purchased servicing component of gross servicing expenses—that is, the amortization of the cost of purchased servicing (ACPC)—rose even faster than the net expense portion, increasing 65 percent to $39.46 per loan in 1986 compared with the $23.88 level of the prior year.

Sales volume in the secondary servicing market appears to have increased in 1986 even though survey respondents on balance gained less in bulk servicing rights than in the previous year. More and more firms are beginning to view both the purchase and sale of servicing rights as a standard part of their operation, to be used for a variety of purposes beyond the traditional function of generating cash flow. Transactions aimed toward portfolio restructuring, in particular, have grown markedly as firms strive for low delinquency, higher average principal balance portfolios. But because these sales typically involve mortgage banking firms trading among each other, each firm's amortization item increases while the total servicing volume for the group as a whole remains little changed. In addition, the greater willingness of the market to deal in smaller blocs of bulk servicing (as small as $20 to $30 million in some cases) has opened the door to many medium to small size firms. All of this has made for a more competitive market, causing an increase in the price of servicing, especially for the highly regarded current production.

Whereas the brisk pace of servicing

The stark rise in unit servicing costs was accompanied by a disappointingly small gain in servicing volume.

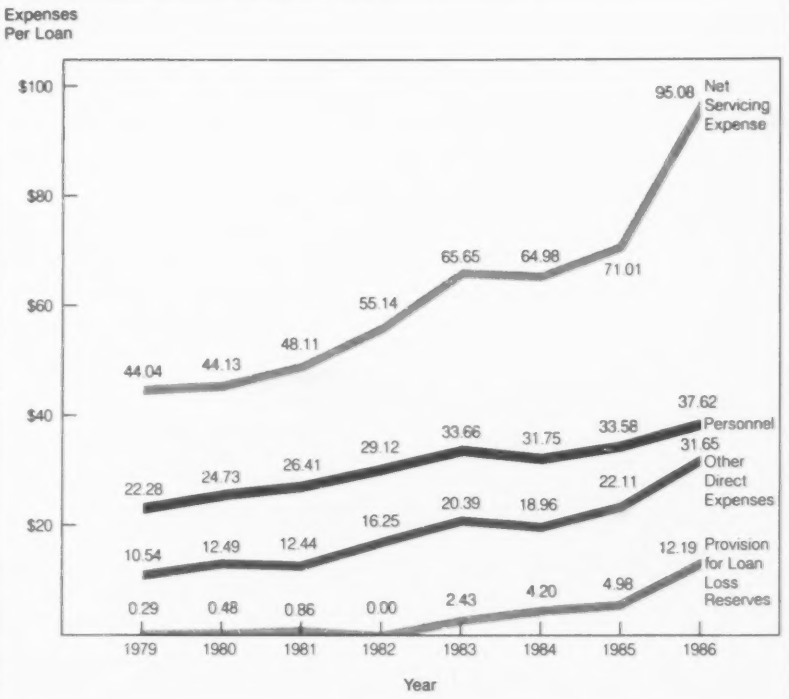
purchases in 1986 added to the ACPC, a large part of the jump in this expense item can be attributed to high prepayment rates. When loans whose servicing rights were purchased prepay at a faster than anticipated rate, the remaining unamortized portion of the purchase price must be expensed at an accelerated rate. Thus a major part of the increase in this item was the moving forward of investment expenses for assets that had depreciated faster than had been anticipated.

Confining our attention to the firms that reported in both 1986 and 1985, the repeat reporters, allows for a closer look at the relationship between the amortization of the cost of purchased servicing and the growth of the servicing portfolio. (ACPC figures are available for both years). These firms comprise 59 percent of the 1986 sample and have per loan figures which are remarkably close to the figures for the entire survey. Thus, they are highly representative of the full list of 1986 reporters.

Repeat reporters showed an increase in the amortization of the cost of purchased servicing of 106 percent in 1986 compared with 1985. During the same period their aggregate dollar volume of servicing rose 14 percent while their number of loans serviced rose only 2 percent. After generating 777,000 in loan originations (the total of in-house plus purchased production) in 1986, these firms ended the year

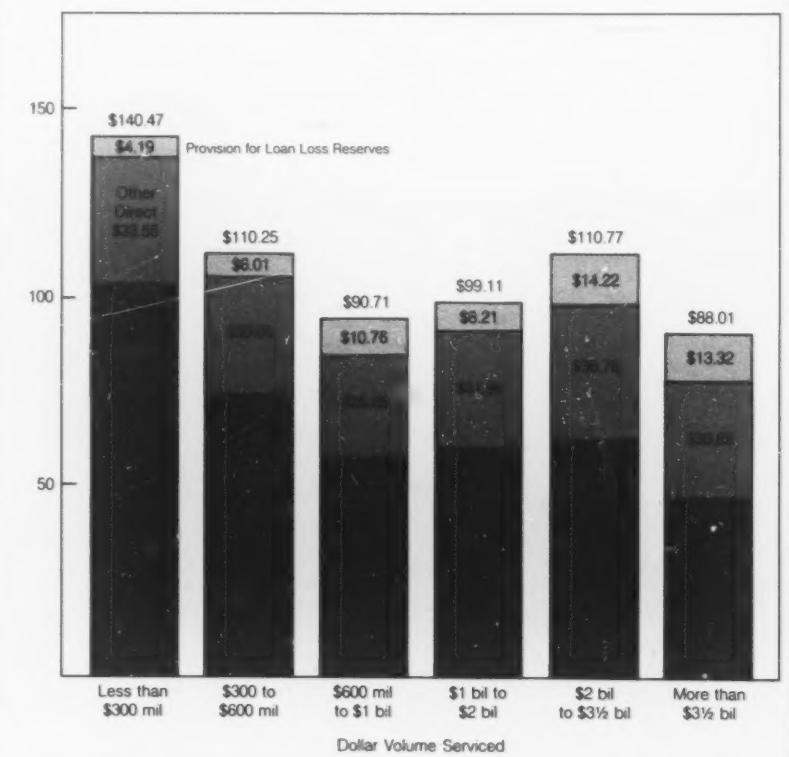
GRAPH 1

Selected Servicing Cost Components, 1979-1986



GRAPH 2

Selected Servicing Cost Components, 1986, by Dollar Volume Serviced



with a net increase in number of loans serviced of only 89,000. Several firms in this group reported substantial increases in the amortization figure while sustaining a decrease in the number of loans serviced. These figures support the view that the premature prepayment of purchased servicing was a large factor underlying the unprecedented jump in the amortization of the cost of purchased servicing item in 1986.

Cost factors

High prepayment rates and deepening delinquency and foreclosure problems were the dominant factors affecting servicing costs in 1986. These factors simply overwhelmed many of the relationships between firm characteristics and unit costs that held in prior years. However, some of these relationships were still found to hold in 1986.

The largest firms, those servicing more than $3½ billion, were found to have the lowest unit costs of the dollar volume size categories—but not by much (See Table 8). These firms averaged $88.01 in expenses per loan serviced, which was $7 below the survey average. However, firms in the $600 million to $1 billion range recorded unit costs of $90.71 while firms in the $2 to $3½ billion range incurred costs of $110.77 per loan. In addition, when the very largest servicers are broken out (those servicing more than $5 billion) their unit costs were a shade higher than those in the $3½ to $5 billion category. Thus, the efficiency to size relationship appears to have been somewhat skewed by the unusual environment of 1986.

The relationship between unit cost and number of loans serviced was much less erratic in 1986 than its dollar volume counterpart. Again, the largest servicers (those servicing more than 80,000 loans) were the most efficient, attaining unit costs of $88.73. However, each of the next three size categories, covering firms servicing from 8,000 to 80,000 loans had almost identical unit costs of approximately $102.

The size breakouts in the 1986 survey show that the area in which the very large firms (more than $3½ billion serviced) enjoyed their greatest advantage was in personnel expenses. For example, the firms in the largest

TABLE 1

Portfolio Dynamics

	1986	1985	1984
Rate of Growth of Dollar Volume Serviced	14.4%	15.1%	13.5%
Rate of Growth of Number of Loans Serviced	3.1%	7.0%	6.9%
Total Servicing Acquisition* Ratio ($)	0.39	0.71	0.70
Average Loan Size Serviced	$41,263	$37,573	$34,946
Percent Increase in Average Size Loan Serviced	9.8%	10.7%	6.4%

*The *total* servicing acquisition ratio is the increase in servicing volume divided by the total of in-house and purchased loan production. It differs from the previously quoted servicing acquisition ratio in that it includes purchased production in the denominator.

TABLE 2

Servicing Income and Expenses* Per Loan, Average Firm, 1984-1986

	1986	1985**	1984
INCOME			
Servicing Fees	$161.12	$148.38	$138.13
Servicing—1st Mortgages	160.65	148.07	137.81
Servicing—2nd Mortgages	0.47	0.31	0.32
Gain Foreclosure	(10.49)	(6.77)	(4.99)
Other Loan Administration Income	29.90	29.19	31.32
GROSS SERVICING INCOME	$180.53	$170.80	$164.35
EXPENSES			
Servicing Personnel	$37.62	$33.58	$31.75
Loan Administration	31.25	27.06	26.47
Management	0.21	0.23	0.22
Directors	0.00	0.00	00.3
Others	0.86	0.99	0.21
Fringe Benefits	5.08	5.30	4.82
Education and Training	0.23	N.C.	N.C.
Occupancy	4.58	3.66	3.67
EDP	9.05	6.68	6.40
Other Direct	31.65	22.11	18.96
Other Equipment	1.67	1.36	1.30
Telephone and Postage	6.69	6.18	5.37
Other Supplies	2.83	2.39	2.10
Travel	0.50	0.61	0.69
Automobile	0.11	0.10	0.21
Advertising	0.07	0.06	0.09
Legal and Auditing	0.91	0.79	0.90
All Other Operating Expenses	18.88	10.62	8.30
Provision for Loan Loss Reserves	12.19	4.98	4.20
NET SERVICING EXPENSE	$95.08	$71.01	$64.98
AMORTIZATION OF THE COST OF PURCHASED SERVICING	$39.46	$23.88	$20.15
NET SERVICING INCOME	$45.99	$75.91	$79.22
Number of Firms	124	101	111

*Only income and expenses that pertain to the day-to-day operation of the servicing operation are included in these figures. Excluded from income are net gains on the sale of servicing rights. Excluded from expenses are items such as amortization of goodwill and of organizational structure that reflect "push down" accounting treatment.
**Income and expense figures for 1985 have been adjusted to incorporate corrections in the data supplied for that year.

dollar volume category incurred personnel expenses per loan of $31.52. No other size range recorded less than $41 for this item. Also, the largest servicers in terms of dollar volume attained an average of 608 loans serviced per employee, compared with the next highest figure of 515 loans serviced per employee in the $600 million to $1 billion range. It appears that the organizational structure of firms in the largest dollar volume servicing category enabled them to better cope with the suddenly increased workload than those in the smaller size categories. Whether this major advantage will carry over into periods of less frantic work pace is an interesting question.

Portfolio turnover

The rapid portfolio turnover in the servicing operation in 1986 made the breakouts in terms of portfolio dynamics less useful than in prior years. While it remained true that a moderate rate of portfolio growth tended to be associated with relatively low unit costs, these costs reflected a higher than normal rate of turnover of loans and were, therefore, significantly higher than their counterparts of previous years. For example, firms with a rate of growth of dollar volume in the 0 to 10 percent range recorded unit costs of $81.45. However, the 0 to 10 percent growth represented a much higher rate of portfolio turnover than this category experienced in prior survey years.

Net losses on foreclosures have been steadily worsening during the past six years and show no sign of improvement in the near future.

The total servicing acquisition ratio, which was designed to take into account the rate of portfolio turnover provides some help in the analysis of the 1986 data. But first it should be noted that this ratio differs from the servicing acquisition ratio introduced in the 1984 study. The *total* servicing acquisition ratio is calculated as the increase in dollar volume serviced divided by the total of in-house plus purchased mortgage loan production. (The servicing acquisition ratio of the 1984 study had only in-house production in the denominator.) This ratio represents the net gain in dollar servicing volume relative to the dollar volume of servicing rights the firm generated during the year. The ratio declines as the result of either large sales of servicing or high prepayment rates or both. A total servicing acquisition ratio in the .9 to 1 range typically indicates an operation in which

TABLE 3

Servicing Income

	1986	1985	1984
INCOME, per loan			
Servicing Fees	$161.12	$148.38	$138.13
Net Gain on Foreclosures	(10.49)	(6.77)	(4.99)
All Other Income	29.90	29.19	31.21
Total Gross Servicing Income	$180.53	$170.80	$164.35
Total Gross Servicing Expense	$134.54	$ 94.89	$ 85.13
Net Servicing Income	$ 45.99	$ 75.91	$ 79.22
Servicing Profit Margin (Before Tax)	25.5%	44.4%	48.2%
Servicing Income as Percent of Dollar Volume Serviced	.438	.455	.470
Net Servicing Income as Percent of Dollar Volume Serviced	.112	.202	.227
Servicing Fees as Percent of Dollar Volume Serviced	.390	.395	.394

TABLE 4

Net Loss On Foreclosures and Provision For Loan Loss Reserves, Per Loan

	1986	1985	1984	1983
Net Loss on Foreclosures	$10.49	$6.77	$4.99	$1.75
Provision for Loan Loss Reserves	$12.19	$4.98	$4.20	$2.43
Rate of Increase of Real Estate Owned above Prior Year	81%	39%	70%	23%

TABLE 5

Servicing Expenses

	1986	1985	1984
EXPENSES, per loan:			
Personnel	$ 37.62	$33.58	$31.75
Occupancy	4.58	3.66	3.67
EDP	9.05	6.68	6.40
Other Direct	31.65	22.11	18.96
Provision for Loan Loss Reserves	12.19	4.98	4.20
TOTAL NET SERVICING EXPENSE	$ 95.08	$71.01	$64.98
Amortization of the Cost of Purchased Servicing	$ 39.46	$23.88	$20.15
Total Gross Servicing Expense	$134.54	$94.89	$85.13
Servicing Expense Ratio*	.230	.189	.186

*Net servicing expense as percent of dollar volume serviced

little servicing is lost and almost all of the loans originated are added to the servicing portfolio.

Firms with total servicing acquisition ratios in the .9 to 1.1 range in 1986 were found to have unit costs of $80.03 and 641 loans serviced per employee. Both figures are significantly better than the survey average. However, the vast majority of firms in the 1986 survey (93 out of 124) had total servicing acquisition ratios below .65. This is to be expected in a high prepayment environment. Unfortunately, costs are not systematically related to the total servicing acquisition ratio when that ratio is in its lower ranges.

Average loan size

Interestingly enough, the categorization that generates the clearest explanation of unit costs is that produced by grouping firms by average loan size serviced. Although this relationship has held in previous years, it was especially striking in the 1986 survey. Firms servicing loans with average principal balance of under $30,000 incurred costs of only $66.82 per loan in 1986. Firms in the $30,000 to $40,000 range experienced unit costs of roughly $82. An orderly upward progression was found to exist up through the more than $65,000 category, where the average firm recorded unit costs of $186.62 (of which $46.03 was in the provisions for loan loss item). The same relationship between loan size and unit costs was found to hold when firms were grouped by unit servicing cost. (See Table 9.)

It is not surprising that the average loan size serviced would correlate especially well with unit costs in a high prepayment rate and high delinquency rate environment. The lower principal balance loans are typically highly seasoned, putting them well beyond the five to seven year loan life range in which delinquency and foreclosure problems typically arise. Also, the lower contract interest rates on these loans make them unlikely refinance candidates, thus holding down their prepayment rate. As a consequence, firms with extremely low average principal balance loans were able to avoid the major cost-inflating factors that characterized the vast majority of servicers.

Further analysis using a measure designed to quantify the degree of seasoning of the servicing portfolio, the loan size ratio, confirms the importance of the degree of seasoning as a major determinant of unit cost in 1986. The loan size ratio, which is defined as the average size loan serviced divided by average size of current production loans, allows for the detection of highly seasoned portfolios of loans that were originated in high cost areas. Firms with a loan size ratio of less than .45 (which compares with the survey average of .56) recorded unit costs of $68.09. (Firms with average loan size serviced under $30,000 had a loan size ratio of .42 in the aggregate.)

Outlook

Despite the run-up in costs last year, the prospects for the servicing operation are promising. The likelihood of another avalanche of refinancings in the near term is small because so many outstanding loans have already been refinanced, and interest rates seem unlikely to drop significantly further. Thus, the run-up in expenses associated with high prepayment rates should be reversed. The increasingly costly delinquency and foreclosure problems are not expected to fade away soon. However, the servicing that was put on the books from 1986 production is of unusually high quality. The underlying loans carry contract interest rates of 9 to 10½ percent and should stay on the books for a relatively long period of time as they are not good refinance candidates in any of the likely interest rate scenarios. They are more strictly underwritten and typically have lower loan-to-value ratios than those originated in the earlier years of the decade. The refinance loans in particular have perhaps the highest value. The fact the borrower was able to consistently meet his mortgage payment obligations at his old rate and will now have lower monthly payments suggests that these loans will face minimal delinquency and foreclosure problems in

TABLE 6

Personnel

	1986	1985	1984
Number of Loans Serviced per Servicing Employee	549	579	591
Average Salary, Loan Administration Personnel	$16,885	$15,187	$15,256
Total Personnel Expenses per Loan	$37.62	$33.58	$31.75
Personnel Expense as Percent of Dollar Volume Serviced	.091	.090	.103
Personnel Expense as Percent of Net Servicing Expense Less Provision for Loan Loss Reserves	45%	51%	52%

TABLE 7

Other Expense Components

	1986	1985	1984
Occupancy Expenses per loan	$4.58	$3.66	$3.67
Occupancy Expenses per Loan Administration Employee	$2,475	$2,053	$2,118
Occupancy Expenses as percent of Dollar Volume Serviced	.011	.010	.011
EDP Expense per loan	$9.05	$6.68	$6.40
EDP Expense per Loan Administration Employee	$4,889	$3,747	$3,687
EDP Expense as percent of Dollar Volume Serviced	.022	.018	.018
Other Direct Expenses per loan	$31.65	$22.11	$18.96
Other Operating Expenses as Percent of Dollar Volume Serviced	.077	.059	.054

TABLE 8

INCOME STATEMENT: Servicing, by Dollar Volume Serviced, 1986

INCOME, per loan	Less Than $300 mil	$300 to $600 mil	$600 to $1 bil	$1 bil to $2 bil	$2 bil to $3½ bil	More than $3½ bil	Average Firm
Servicing Fees	$186.28	$176.38	$177.15	$160.73	$172.86	$154.24	$161.12
Net Gain Foreclosure	(11.38)	(27.63)	(13.88)	(8.12)	(16.94)	(7.73)	(10.49)
All Other Income	28.80	29.64	23.48	34.26	23.90	31.42	29.90
TOTAL SERVICING INCOME	$203.69	$178.39	$186.74	$186.87	$179.81	$177.92	$180.53
EXPENSES, per loan							
Personnel	$ 73.37	$ 52.56	$ 41.97	$ 44.25	$ 44.90	$ 31.52	$ 37.62
Occupancy	13.86	6.80	4.95	4.18	5.64	3.99	4.58
EDP	15.51	14.83	7.78	10.50	9.24	8.30	9.05
Other Direct	33.55	30.06	25.25	31.96	36.78	30.88	31.65
Provision for Loan Loss Reserves	4.19	6.01	10.76	8.21	14.22	13.32	12.19
TOTAL NET SERVICING EXPENSE	$140.47	$110.25	$ 90.71	$ 99.11	$110.77	$ 88.01	$ 95.08
ACPC (Amortization of cost of purchased servicing)	$ 7.44	$ 25.48	$ 23.59	$ 24.88	$ 39.88	$ 46.63	$ 39.46
NET SERVICING INCOME	$ 55.78	$ 42.65	$ 72.44	$ 62.88	$ 29.16	$ 43.28	$ 45.99
ANCILLARY DATA							
Servicing Fee (%)	0.413	0.430	0.431	0.375	0.400	0.383	0.390
Servicing Expense Ratio	0.311	0.269	0.221	0.232	0.257	0.219	0.230
Net Servicing Income (%)	0.124	0.104	0.176	0.147	0.068	0.108	0.112
Profit Margin (Before Tax)	27.4%	23.9%	38.8%	33.6%	16.2%	24.3%	25.5%
# Loans Serviced Per Employee	313	404	515	489	511	608	549
Average Salary, Loan Administration	$17,865	$16,460	$16,341	$18,235	$18,617	$15,930	$16,885
Average Loan Size Serviced	$45,145	$40,997	$41,084	$42,805	$43,178	$40,238	$41,263
Percent Growth of Dollar Volume Serviced	14.4%	14.7%	11.5%	20.9%	8.7%	15.0%	14.4%
Total Servicing Acquisition Ratio	0.11	0.29	0.33	0.41	0.28	0.45	0.39
Number of Firms	25	17	21	27	16	18	124

TABLE 9

Servicing Expenses, Per Loan: Grouped By Unit Cost

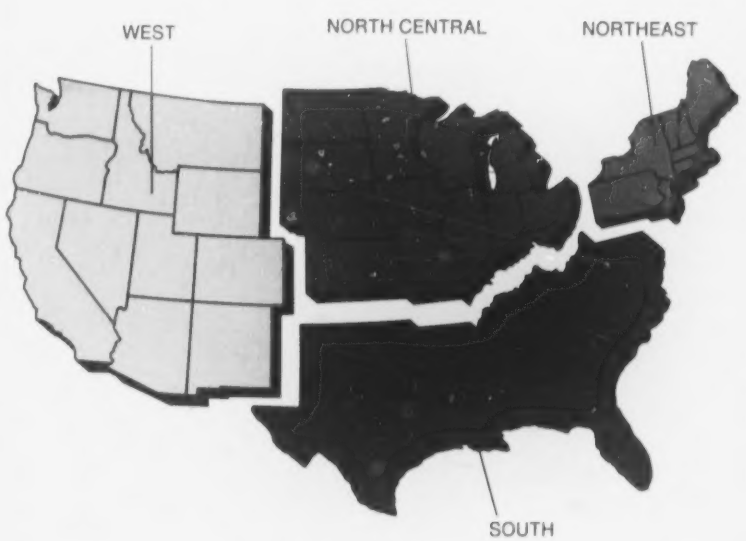
EXPENSES, per loan	Less Than $70	$70 to $80	$80 to $100	$100 to $125	$125 to $175	More than $175	Average Firm
Personnel	$28.02	$34.08	$31.69	$ 43.38	$ 56.93	$ 71.33	$37.62
Occupancy	2.51	3.54	3.46	7.02	6.61	9.46	4.58
EDP	4.81	7.09	6.48	14.95	11.49	18.91	9.05
Other Direct	21.27	26.67	24.56	40.83	49.40	65.22	31.65
Provision for Loan Loss Reserves	1.09	1.75	23.49	5.05	24.68	74.62	12.19
TOTAL NET SERVICING EXPENSE	$57.70	$73.14	$89.68	$111.22	$149.12	$239.54	$95.08
ACPC (Amortization of the cost of purchased servicing)	$36.26	$30.42	$45.10	$46.25	$34.13	$25.01	$39.46
ANCILLARY DATA							
Servicing Fee (%)	0.342	0.423	0.395	0.389	0.449	0.416	0.390
Profit Margin (Before Tax)	36.3%	39.1%	23.3%	18.5%	22.0%	0.7%	25.5%
Servicing Expense Ratio	0.158	0.199	0.223	0.251	0.312	0.405	0.230
# Loans Serviced Per Employee	627	581	621	515	400	378	549
Average Loan Size Serviced	$36,562	$36,758	$40,278	$44,325	$47,730	$59,092	$41,263
Percent Growth of Dollar Volume Serviced	10.9%	9.4%	18.1%	18.4%	11.1%	24.0%	14.4%
Total Servicing Acquisition Ratio	0.39	0.39	0.40	0.44	0.26	0.33	0.39
Number of Firms	24	19	22	21	20	18	124

TABLE 10

Income Statement, Servicing, by Geographical Region (1986)

INCOME, per loan	Northeast	South	Midwest	West	Average Firm
Servicing Fees	$181.25	$162.88	$130.76	$183.02	$161.12
Net Gain Foreclosure	(0.98)	(11.42)	(7.41)	(24.96)	(10.49)
All Other Included	26.36	28.96	32.53	33.73	29.90
TOTAL SERVICING INCOME	$206.63	$180.42	$155.88	$191.79	$180.53
EXPENSES, per loan					
Personnel	$ 36.92	$ 35.73	$ 34.00	$ 48.48	$ 37.62
Occupancy	5.60	4.12	3.67	5.86	4.58
EDP	12.86	8.25	6.81	8.40	9.05
Other Direct	32.34	29.44	30.28	39.11	31.65
Provision for Loan Loss Reserves	12.22	12.86	11.08	11.56	12.19
TOTAL NET SERVICING EXPENSE	$ 99.93	$ 90.40	$ 85.94	$113.41	$ 95.08
ACPC	$ 44.03	$ 35.26	$ 37.45	$ 46.16	$ 39.46
NET SERVICING INCOME	$ 62.67	$ 54.76	$ 32.59	$ 32.22	$ 45.98
Profit Margin (Before Tax)	30.3%	30.4%	20.9%	16.8%	25.5%
Servicing Fee (%)	.422	.406	.349	.376	.390
Loans Serviced per Employee	546	543	608	478	549
Average Salary, Loan Administration	$16,267	$16,176	$15,315	$19,812	$16,885
Growth in Dollar Serviced	12.3%	12.7%	29.2%	3.6%	14.4%
Growth in Number Serviced	3.8%	2.7%	11.8%	−11.4%	3.1%
Total Servicing Acquisition Ratio	.315	.379	.668	.099	0.39
Servicing Expense Ratio	.233	.225	.229	.233	.231
Average Loan Size	$42,961	$40,123	$37,466	$48,648	$41,263
Occupancy Expense per employee	$ 3,002	$ 2,208	$ 2,112	$ 2,984	$ 2,475
EDP Expense per Loan Administration Personnel	$ 6,890	$ 4,424	$ 3,920	$ 4,269	$ 4,889
Number of firms	16	48	34	26	124

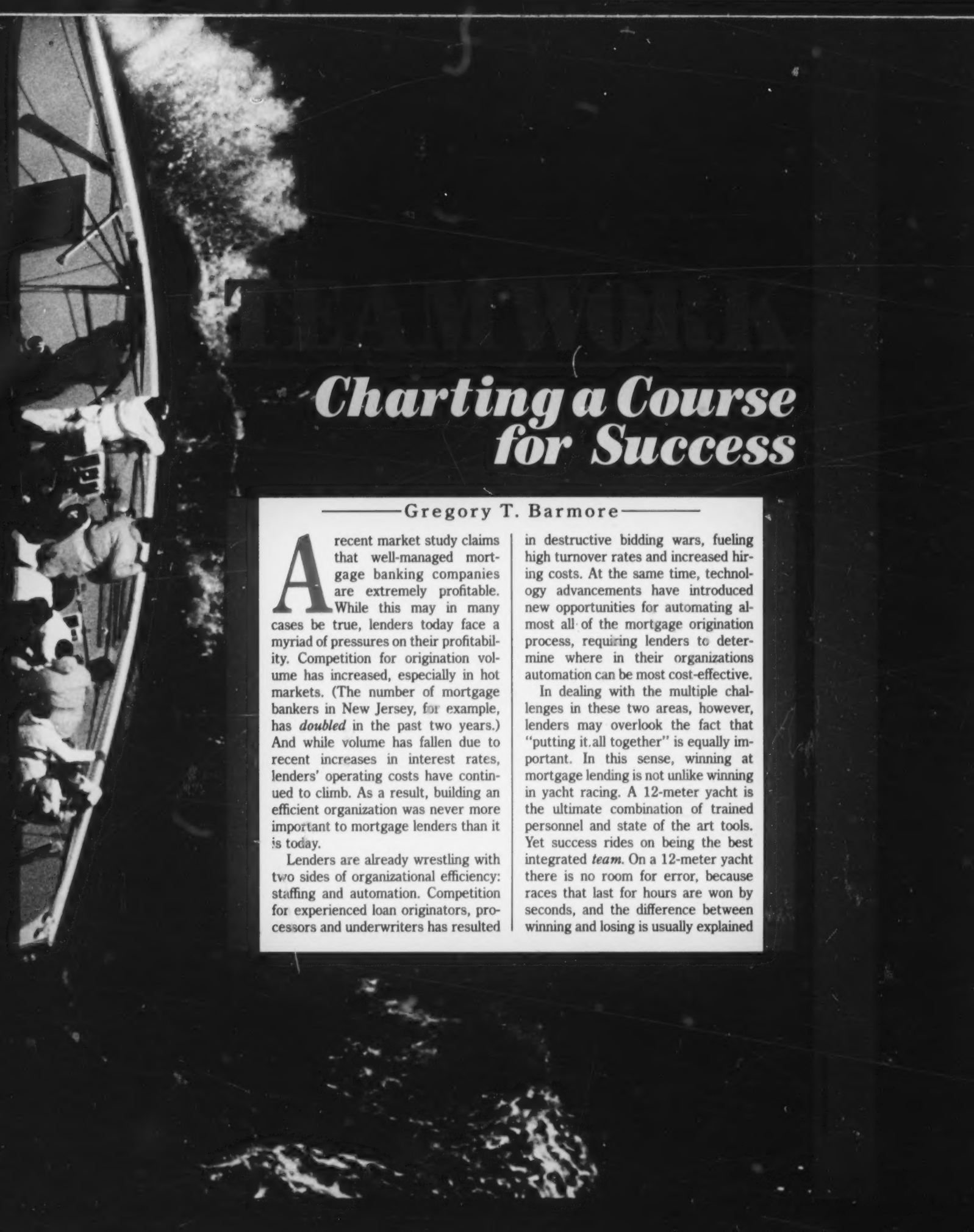
Geographic Regions



the future. Thus, efficient mortgage servicers, especially those who added appreciably to their portfolios from 1986 production, can expect significant improvement in net income in the years ahead. □

The data upon which this study is based was generated by the Mortgage Bankers Association's Mortgage Banking Financial Statements Survey. The 124 respondents to the 1986 survey represent a sizeable portion of the mortgage banking industry, accounting for approximately 40 percent of total single-family originations in this sector. MBA wishes to thank the respondents for their participation.

A more detailed breakdown of the servicing figures, as well as income statements for the single-family loan production, warehousing and marketing operations will be available in the MBA publication, *Income and Costs for Orgination and Servicing of 1 to 4 Unit Residential Loans, 1986* to be released this September.



Charting a Course for Success

Gregory T. Barmore

A recent market study claims that well-managed mortgage banking companies are extremely profitable. While this may in many cases be true, lenders today face a myriad of pressures on their profitability. Competition for origination volume has increased, especially in hot markets. (The number of mortgage bankers in New Jersey, for example, has *doubled* in the past two years.) And while volume has fallen due to recent increases in interest rates, lenders' operating costs have continued to climb. As a result, building an efficient organization was never more important to mortgage lenders than it is today.

Lenders are already wrestling with two sides of organizational efficiency: staffing and automation. Competition for experienced loan originators, processors and underwriters has resulted in destructive bidding wars, fueling high turnover rates and increased hiring costs. At the same time, technology advancements have introduced new opportunities for automating almost all of the mortgage origination process, requiring lenders to determine where in their organizations automation can be most cost-effective.

In dealing with the multiple challenges in these two areas, however, lenders may overlook the fact that "putting it all together" is equally important. In this sense, winning at mortgage lending is not unlike winning in yacht racing. A 12-meter yacht is the ultimate combination of trained personnel and state of the art tools. Yet success rides on being the best integrated *team*. On a 12-meter yacht there is no room for error, because races that last for hours are won by seconds, and the difference between winning and losing is usually explained

by the mistakes of the loser. The winner is the one with perfect execution, and that requires top performance from each crew member, aimed at ensuring the team's success.

Building teamwork through corporate goals

Instilling this teamwork mentality in an organization means that each person "buys into" the company's goals. This requires first that clear goals be established based upon consensus from those with responsibility for achieving them—not just top management. For example, branch office staff responsible for marketing new loan programs should have a say in setting related volume objectives. Loan processors who face daily struggles to collect loan package documents should participate in establishing loan turnaround time goals.

Assigning accountability for goals also implies delegating the authority to make decisions that will affect how well these goals are achieved. Companies function most efficiently when people with the most knowledge of an issue or problem are charged with solving it. Improving customer service or streamlining paperwork flows may be best addressed by local office managers, because they have more knowledge of staffing, personnel skills and daily business traffic. Conversely, product development may be most successful when handled centrally (with input from field operations), because of the many financial, marketing and administrative issues involved.

Senior management's role in the goal-setting process is to refine and consolidate specific goals into overall corporate objectives, and to keep the organization focused on its goal of being first across the finish line. (Steven Jobs, founder of Apple Computers, defines a leader as the "keeper and reiterator of a vision.")

Several recent articles claim that successful mortgage bankers do not rely on strategic planning, but instead react quickly and decisively to market opportunities as they arise. However, a General Electric Mortgage Insurance Company (GEMICO) survey conducted last year indicated that lenders do indeed set specific goals within which most activities are focused. Four goals were cited by a majority of the 350 lenders surveyed and is shown in Table 1.

TABLE 1

Goal	Percent of respondents
Increase market share	79%
Build positive image	75%
Reduce costs	68%
Build market leadership	63%

Gregory T. Barmore is president of GE Mortgage Insurance Companies.

The winner is the one with perfect execution, and that requires top performance from each crew member, aimed at ensuring the team's success.

On the other hand, there was much less agreement among lenders on how to achieve these goals; the most popular strategies (targeting specific types of customers, increasing the number of branches, developing new products, or automating functions) each were cited by only one-third of the respondents.

As the GEMICO survey illustrates, lender organizations often have apparently conflicting goals (*e.g.*, increasing branch office coverage to expand market share while at the same time reducing costs). This is not a tactical error, but instead a reflection of the market reality that what works in the short run may not be the best recipe for long-term success. Forward-looking organizations are those that see *both* short and long term, and senior management must foster this perspective at all organizational levels.

Once goals are established, it is important to identify each person's role in achieving them and communicate this throughout the organization. The purpose of this step is twofold: It emphasizes the fact that every individual must be a top performer if the company is to succeed, and it builds appreciation for others' roles in the team's effort. Anyone who has searched in vain for a loan file appreciates a file clerk's contribution to company efficiency. Anyone who has ever been put on hold while making a phone call recognizes how important receptionists are in providing good customer service. However, these contributions are frequently overlooked when things are running smoothly, and similar contributions by other personnel (branch managers, information systems staff, secretaries, etc.) may be less noticeable—at least until they are no longer there.

Periodically measuring the company's performance against its objectives, and communicating the findings to the individual team members is also critical. In this way, management's commitment to attaining these goals is made clear. At the same time, this provides a consistent standard against which all efforts can be measured. Most importantly, this affirms or strengthens individual team members' acceptance of company goals. Imagine again the 12-meter yacht with every crew member except the captain wearing a blindfold. Even if each person could accomplish his assigned task, think how much more motivated the team would be if it could see where competitors' yachts were and knew the distance to the finish line.

Fostering continued teamwork

Once corporate goals are accepted, management must continue to motivate and compensate employees in a manner that fosters teamwork. First and foremost, this means promoting open communication among all levels in the organization, and particularly between different functions. While it is critical that each team member embrace common goals, this does *not* mean that everyone will always agree on how things should be done. For example, lenders entering new markets can do so either by expanding their branch office network or developing correspondent relationships.

Similarly, employees on the "front line" should be encouraged to keep management informed on developing problems and opportunities, so that responses can be implemented

Ken Richardson, Inc.
EXECUTIVE SEARCH AND RECRUITMENT CONSULTANTS TO THE THRIFT & REAL ESTATE FINANCE INDUSTRIES

- Established 1970
- A member of the Mortgage Bankers Association of America and the National Council of Savings Institutions
- Co. headquarters (301) 365-2116 7501-M Democracy Blvd., Bethesda, MD 20817
- Ken Richardson, S.E. (904) 767-7133 6060-M Hensel Rd. Port Orange, FL 32019

A NEW MARK OF EXCELLENCE

MSA™
MASTER SENIOR APPRAISER

The Master Senior Appraiser (MSA) is the mark of a dedicated professional appraiser. It is one who has completed a minimum of five specialized appraisal courses, subscribed to a strict code of ethics, and has agreed to conform to the association's comprehensive standards of practice.

The National Association of Master Appraisers, with more than 3,000 members in 37 states, is one of the fastest growing organizations of its kind.

For more information on how you may become a designated member, write or call on the toll-free numbers below.

FOR FURTHER INFORMATION CALL OR WRITE
NATIONAL 1-800-531-5333
TEXAS 1-800-292-5620
National Association Master Appraisers
303 W. Cypress, San Antonio, TX 78212

promptly. For instance, GEMICO recently revised its underwriting guidelines on condominiums and investment properties in Colorado based upon recommendations from the local sales representative and branch manager. After their discussions with lenders, appraisers and Realtors confirmed their suspicions about growing problems with these properties, employees suggested policy changes that reduce the excess risk GEMICO accepts on these products while continuing to meet market needs.

This kind of initiative is unlikely to occur unless compensation plans designed to award top performers can also be structured to promote teamwork. For example, traditional incentive plans at GEMICO compensated sales representatives based upon business volume obtained, with underwriter personnel paid on a regular wage basis. While this ensured that each group performed their assigned tasks well, it also promoted an "us versus them" mentality. As long as business volume and quality were relatively high, this attitude did not significantly impair efficiency. However, when branch office turnover temporarily affected service levels or the quality of loans submitted by a specific lender deteriorated, this protectionist attitude actually *slowed* resolution of the problem.

Now, GEMICO sales personnel are paid based upon both business volume and quality, and underwriting managers receive bonuses based upon customer service levels, delinquency measurements and knowledge of local market conditions. In addition, yearlong promotional campaigns are conducted for teams of sales and operations employees at each GEMICO insurance service center, with winning teams receiving free trips to various locations. This year, teams will be measured on underwriting quality, lender quality, local economic market knowledge, customer service levels and new business generated. Based upon results of previous contests, the costs for the winning trips are small compared to the financial gain GEMICO earns from added volume and business quality. Even greater is the increase in motivation exhibited by contest winners—they return from their trips determined to win again the following year.

Lenders are already wrestling with two sides of organizational efficiency: staffing and automation.

GEMICO's experience in its Seattle office dramatically illustrates the benefits realized by creating a teamwork mentality. During 1985, GEMICO's market share in Washington hit an all-time low, and delinquencies and loan declinations skyrocketed due to deteriorating business quality. At the beginning of 1986, faced with the prospect of withdrawing from the state, GEMICO's branch manager and newly-hired experienced sales representatives began to work together to turn the situation around. First, everyone agreed that their goal would be to increase the volume of quality business received from Washington lenders. Second, everyone on the team demonstrated a willingness to "wear different hats" to see this task accomplished. Sales reps met with lenders to discuss underwriting problems, and supported (rather than second-guessed) underwriters when loans were declined. At the same time, branch office underwriters accompanied sales reps on customer calls, and loan processors served as unofficial customer service reps. The result: GEMICO market share in Washington has more than doubled, while loan declinations have been cut in half and delinquency rates have dropped from 3.05 percent to 2.52 percent, lower than the average for all mortgage insurers.

Building teamwork with other industry participants

Mortgage lenders do not operate in a vacuum. Instead, they rely on other industry players to provide business referrals (Realtors) and specific services and products (appraisal compa-

ARE YOU AN OVER ACHIEVER?

Then Corporate Management Advisors (CMA) is interested in your future. CMA is a national management consulting firm specializing in executive advancement throughout The Real Estate Finance Industry. CMA is presently conducting searches in the following areas:

- Senior Management Residential
- Regional Residential Manager
- Residential Branch Managers
- Income Property Lenders
- Secondary Marketing
- Loan Administration Manager
- Collections Manager
- Foreclosure/REO Manager

If you're looking for an annual compensation ranging from $35,000 to $200,000, call or write us today in complete confidence. Corporate Management Advisors provides over-achievers with the right career opportunities and organizations with the right individuals.

Bruce Kuiper & Brad Hollingsworth
Senior Partners

CMA

(305) 869-1817
Corporate Management Advisors, Inc.
455 Douglas Avenue - Suite 1455
Altamonte Springs, FL 32714

REMIC, CMO, and MBS SYSTEMS

Systems
that will save you lots of money.

Systems
that support issuers, trustees, holders, and custodians of mortgage-related securities.

Systems
that are accurate, dependable, flexible, and responsive—giving you what you need when you need it.

Systems
that are already processing billions of dollars worth of CMOs, GINNIE MAES, GPMs, FANNIE MAES, and FREDDIE MACS.

Business solutions that are available NOW.

CALL FOR MORE INFORMATION
(818) 992-7557

C.D.B.
COMPUTER CORPORATION
21243 Ventura Blvd. • Suite 205
Woodland Hills, California 91364

nies, mortgage insurers, attorneys, etc.). Because *lender* resources must be used to convert referrals into loan applications, to prepare mortgage insurance application packages, to evaluate appraisals, to service loans, and so on, improving teamwork with other players can also improve a lender's internal efficiency.

GEMICO has taken this approach as part of its customer management strategy. If, for example, delinquency experience with a specific lender deteriorates, GEMICO does not respond by automatically cutting the lender off for future business or start looking for ways to deny claims on technicalities. Instead, GEMICO personnel try to work with the lender to identify both the problems and possible solutions. In some cases, sales representatives or underwriters have conducted loan processing seminars to help train inexperienced lender employees. In other cases, GEMICO has operated as a consulting service by working directly with lenders' servicing departments to help improve collection techniques and identify alternatives to foreclosure (such as modification on high coupon-rate loans). The resulting improvement in loan package quality or claims mitigation more than offset GEMICO's cost in providing these services, and at the same time an ongoing productive relationship with the customer was established.

Lenders have a significant opportunity to improve internal efficiency by working closely with Realtors, whose influence in the loan origination process is growing more pronounced. A recent Mortgage Bankers Association (MBA) study among Realtors disclosed that 90 percent are involved in many aspects of the financing process: from explaining various loan options and prequalifying borrowers to actually recommending specific lenders as sources of financing. Clearly, how well Realtors perform these tasks will directly influence the level of lender effort required to turn a loan referral into a closed loan. Therefore, lenders must keep Realtors informed not only on prevailing mortgage interest rates, but also on new loan programs being introduced, changing loan documentation requirements, or revised borrower qualification requirements.

Lenders will benefit in two ways from this effort. First, by ensuring that borrower referrals more closely meet lender requirements, loan processing time and effort will be shortened. Second, the solidified business relationship with a Realtor should increase the volume of loan referrals, because the MBA study has shown that Realtors view lender responsiveness, salesmanship, and reputation as important as loan interest rates when making a recommendation.

GEMICO is also working to improve its ability to work with Realtors, because their actions indirectly affect business volume and quality as well. GEMICO has created a "Mortgage Insurance Update for Realtors" package, consisting of three brochures detailing basic information on mortgage insurance, the underwriting approach to 95 percent loan-to-value mortgages, and GEMICO's new premium financing plan that is competitive with FHA's program. These brochures also outline key points that should be conveyed to potential homebuyers, thereby improving the Realtors' ability to serve their customers. In addition, GEMICO sales and underwriting personnel are conducting mortgage insurance information/education sessions with various Realtor boards and agencies, frequently in conjunction with lenders. This Realtor campaign was not devised as a short-term project, but rather an ongoing element of business, because it is perceived that improved teamwork with Realtors will enhance GEMICO performance.

The challenges of turning talented individuals and sophisticated technologies into a smooth-sailing company are many. Creating a focus on teamwork can be accomplished by establishing clear goals based upon the consensus of those charged with achieving them, defining the role each employee will play in reaching chosen objectives, motivating and compensating personnel based upon complementary (rather than contradictory) standards, and measuring and providing feedback on team performance. In addition, significant opportunities exist for fostering teamwork with other industry players who share lenders' goal of promoting homeownership. Lenders who succeed in building a well-integrated team have their 12-meter yacht on the right tack for capturing their own America's Cup. □

Recent economic indicators suggest that GNP growth will slow substantially in the second and third quarters from the robust first quarter pace. For example, payroll employment and aggregate hours worked in the second quarter increased at much slower rates than in the first quarter.

Several components of GNP will account for the slowdown. Inventory investment and residential investment are expected to slow markedly or decline. Real personal consumption expenditures, which account for about two-thirds of the GNP, will increase only moderately. While these components of GNP are likely to contribute to slower growth, net exports is expected to show continued improvement. The improvement partially reflects previous changes in the exchange value of the dollar. Improvement in real net exports started in the fourth quarter of 1986, continued in the first quarter, and will act as an important element of strength to the economy in the second and third quarters.

The sluggishness of the economy has helped keep a lid on inflation. Increases in both producer prices and consumer prices have moderated in recent months after a temporary surge in oil, food, and import prices pushed up the inflation rate earlier this year. Producer prices of finished goods increased only 0.3 percent in May and 0.2 percent in June, and, excluding the volatile food and energy components, showed little change in May and June. Similarly, the May increase in the consumer price index was only 0.3 percent—the smallest monthly increase this year. These recent statistics support the view that the inflation rate is unlikely to accelerate above 4 to 5 percent this year.

The sluggishness of the economy and moderate inflation have helped stabilize bond prices in recent weeks. Several factors will play an important role in credit markets in the months ahead: the exchange value of the dollar, the stance of monetary policy, the federal budget deficit and inflation expectations.

These factors are interrelated. Until the recent recovery of the dollar against the yen and the West German mark, there was growing market sentiment that rising import prices would cause an acceleration of inflation and would force the Federal Reserve to tighten credit further to bolster the dollar. These fears have now been allayed. With the sluggish economy, a rebounding dollar, and moderate inflation, the Federal Reserve has more flexibility in providing an accommodative monetary policy.

The federal budget deficit remains a problem. Rapid growth in federal debt due to large deficits continues to flood credit markets with government securities, keeping interest rates higher than they otherwise would be. The mid-session review of the federal budget this summer will once again focus attention on the outlook for the deficit. The deficit will decline substantially in fiscal year 1987, probably to around $165 billion, but it may be difficult to make further progress in fiscal year 1988.

With heavy credit demands from the federal government likely to continue, large capital inflows from abroad will be needed to keep interest rates from rising. A stronger exchange value of the dollar is important in this respect. If the dollar is expected to increase in value, foreign investors are more likely to invest in U.S. securities because they will profit from both the relatively attractive returns on U.S. securities and currency appreciation.

Finally, inflation expectations will play a critical role in the determination of nominal interest rates. The strengthening of the dollar has served to dampen inflation expectations. However, movements in oil prices remain a possible concern. If tensions in the Middle East escalate, threaten the supply of oil, and sharply increase oil prices, inflation expectations would rise as a result and drive up nominal interest rates. Hopefully, this will not happen. In any event, the prospects for relatively stable interest rates seem greater than a few weeks ago.

Thomas M. Holloway
Senior Economist
July 10, 1987

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES, BY UNIT TYPE

(Units in thousands)

YEAR AND MONTH	HOUSING STARTS						PERMITS 17,000 ISSUING PLACES					
	Actual			Seasonally Adjusted Annual Rates			Actual			Seasonally Adjusted Annual Rates		
	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units
1986												
DEC	114	80	34	1,813	1,341	472	132	82	50	1,862	1,289	573
1987												
JAN	105	75	30	1,816	1,332	484	102	69	33	1,652	1,181	471
FEB	103	76	27	1,838	1,379	459	101	76	25	1,676	1,313	363
MAR	141	107	34	1,730	1,296	434	150	109	41	1,719	1,244	475
APR	162	126	36	1,620	1,287	378	157	117	40	1,598	1,152	446
MAY_p	160	121	39	1,665	1,204	416	135	104	31	1,477	1,097	380
1986 TOTAL	1,806	1,263	543				1,769	1,185	584			
1985 TOTAL	1,742	1,166	576				1,733	1,077	657			
5 MONTHS												
1987	670	504	166				647	477	170			
1986	749	514	235				735	486	249			
1985	691	472	219				687	440	247			
1984	730	510	220				727	474	253			

RESIDENTIAL STRUCTURES BY REGION

(Units in thousands)

YEAR AND MONTH	STARTS								PERMITS 17,000 ISSUING PLACES							
	Actual				Seasonally Adjusted Annual Rates				Actual				Seasonally Adjusted Annual Rates			
	North East	Mid-West	South	West	North East	Mid-West	South	West	North East	Mid-West	South	West	North East	Mid-West	South	West
1986																
DEC	19	19	39	36	309	394	602	508	21	19	43	49	284	303	567	708
1987																
JAN	16	16	44	29	336	431	589	460	14	14	41	29	286	362	568	436
FEB	10	14	45	34	291	371	675	501	15	16	43	27	319	388	577	392
MAR	22	24	57	40	296	348	616	470	25	26	60	41	317	335	624	443
APR	26	29	66	41	275	310	672	408	27	32	58	41	290	305	588	415
MAY_p	28	33	61	38	294	316	630	380	26	27	48	33	273	278	562	364
1986 TOTAL	294	296	733	484					283	290	687	510				
1985 TOTAL	252	240	782	468					260	237	753	484				
5 MONTHS																
1987	101	115	272	182					108	114	251	174				
1986	104	103	335	207					103	108	312	211				
1985	83	83	333	193					98	82	314	194				
1984	63	83	391	194					73	80	371	203				

HOUSING ACTIVITY (Cont'd.)

YEAR AND MONTH	HOUSING SALES (Units in thousands) EXISTING HOUSES[1]	NEW HOMES Sold	NEW HOMES Available For Sale	NEW HOMES Months Supply at Current Rate	VALUE OF NEW CONSTRUCTION PUT IN PLACE (Dollars in billions) Seasonally Adjusted Annual Rate Total	1 Unit	2+ Units	Non-res.	CONSTRUCTION STATUS (Units in thousands) Seasonally Adjusted Annual Rate Under Construction Total	1-4 Units	5+ Units	Completions Total	1-4 Units	5+ Units
1986														
DEC	268	49	357	5.8	227.3	107.4	30.2	89.7	1,104	658	446	175	120	55
1987														
JAN	216	53	358	6.2	222.4	107.9	29.4	85.1	1,089	658	431	137	91	46
FEB	241	59	358	6.1	224.5	108.5	28.4	87.6	1,096	669	427	118	78	40
MAR	325	72	358	6.1	225.9	112.0	27.5	86.4	1,085	669	416	127	86	41
APR	331	71	360	5.9	225.0	112.9	27.1	85.0	1,075	676	399	135	94	41
MAY$_p$	344	58	356	7.1	227.8	113.1	28.4	86.3	1,081	686	395	130	93	37
1986 TOTAL	3,565	749										1,756	1,206	550
1985 TOTAL	3,214	688										1,704	1,170	534
5 MONTHS														
1987	1,465	314										646	440	206
1986	1,373	363										649	438	211
1985	1,225	295										624	423	201
1984	1,200	293										610	416	194

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED

By Type of Institution and By Unit Type

(Dollars in millions)

YEAR AND MONTH	TOTAL Total	Mtg. Bankers[9]	S&Ls	Banks[2]	Life Cos.	1-4 UNITS Total	Mtg. Bankers[9]	S&Ls	Banks[2]	Life Cos.
1986										
SEP	$58,193	$14,360	$20,289	$20,576	$2,968	$42,621	$12,648	$16,668	$12,870	$435
OCT	56,285	12,659	20,760	19,781	3,085	41,901	11,535	16,992	12,985	389
NOV	52,157	12,703	16,813	18,141	4,500	37,493	12,136	13,634	11,307	416
DEC	74,941	14,615	26,639	27,478	6,209	47,459	13,148	19,298	14,720	293
1987										
JAN	42,804	9,748	12,888	18,641	1,527	31,397	8,791	10,453	11,932	221
FEB$_p$	44,756	10,518	13,128	19,103	2,007	31,486	10,012	10,773	10,534	167
1986 TOTAL	603,948	142,884	218,118	205,503	37,443	438,441	131,628	176,063	126,936	3,814
1985 TOTAL	369,343	68,065	145,372	127,873	28,033	241,474	62,658	109,286	68,224	1,306
2 MONTHS										
1987	87,559	20,266	26,016	37,743	3,534	62,884	18,803	21,226	22,467	388
1986	53,813	11,323	20,990	18,215	3,285	35,286	10,494	16,050	8,509	233
1985	40,695	7,827	15,863	14,675	2,330	26,393	7,468	11,340	7,483	102
1984	41,319	9,180	15,539	14,878	1,722	27,059	7,540	11,563	7,866	90

LENDER ACTIVITY (Cont'd.)

LONG-TERM LOANS CLOSED (Cont'd.)

(Dollars in millions)

YEAR AND MONTH	5+ UNITS					NONRESIDENTIAL				
	Total	Mtg. Bankers[9]	S&Ls	Banks[2]	Life Cos.	Total	Mtg. Bankers[9]	S&Ls	Banks[2]	Life Cos.
1986										
SEP	$4,769	$1,326	$1,897	$1,312	$234	$10,803	$386	$1,724	$6,394	$2,229
OCT	3,560	735	1,933	735	157	10,824	389	1,835	6,061	2,539
NOV	2,661	190	1,537	576	358	12,003	377	1,642	6,258	3,726
DEC	6,753	919	3,629	1,677	528	20,729	548	3,712	11,081	5,388
1987										
JAN	2,868	529	1,330	877	132	8,539	428	1,105	5,832	1,174
FEB$_p$	2,664	222	1,149	1,053	240	10,606	284	1,206	7,516	1,600
2 MONTHS										
1987	5,532	751	2,479	1,930	372	19,143	712	2,311	13,346	2,774
1986	4,187	409	2,317	1,036	425	14,340	420	2,623	8,670	2,627
1985	2,705	61	1,614	795	235	11,597	298	2,909	6,397	1,993
1984	3,753	890	1,677	991	195	10,507	750	2,299	6,021	1,437

LONG-TERM COMMITMENT ACTIVITY

By Type of Institution

(Dollars in millions)

YEAR AND MONTH	ISSUED DURING MONTH					OUTSTANDING				
	Total	Mtg. Bankers[9]	S&Ls	Banks[2]	Life Cos.	Total	Mtg. Bankers[9]	S&Ls	Banks[2]	Life Cos.
1986										
SEP	$48,050	$11,297	$19,442	$15,024	$2,287	$159,746	$25,320	$51,957	$62,601	$19,868
OCT	43,470	8,959	19,202	12,593	2,716	138,410	17,784	49,878	51,605	19,143
NOV	35,692	8,263	17,111	7,554	2,764	129,766	20,974	48,994	40,726	19,072
DEC	43,851	13,033	19,548	7,979	3,291	124,202	23,189	43,014	41,809	16,190
1987										
JAN	29,909	7,044	13,718	6,674	1,663	116,720	18,703	40,419	41,594	16,004
FEB$_p$	34,416	10,941	11,585	9,599	2,291	137,452	20,664	49,401	51,121	16,266
1986 TOTAL	527,397	128,480	231,915	127,902	39,100					
1985 TOTAL	324,089	59,551	170,755	61,311	32,472					
2 MONTHS										
1987	63,515	17,985	25,303	16,273	3,954					
1986	59,191	15,649	26,820	11,708	5,014					
1985	38,761	7,454	19,971	7,172	4,164					
1984	37,648	8,640	19,650	6,405	2,953					

MORTGAGE INSURANCE

(Units in thousands, Dollars in millions)

YEAR AND MONTH	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	Total	FHA[3]	VA	Private	Total		FHA(203)		VA		Private	
					Units	Amt.	Units	Amt.	Units	Amt.	Units	Amt.
1986												
DEC	215	111	39	65	176	$12,313	88	$5,531	39	$2,768	49	$4,014
1987												
JAN	208	120	41	47	176	12,234	96	5,955	38	2,718	42	3,561
FEB	243	153	42	48	168	11,587	91	5,520	44	3,255	33	2,812
MAR	307	190	49	68	248	16,979	149	9,220	60	4,420	39	3,339
APR	285	165	41	79	229	15,857	144	9,036	41	3,021	44	3,800
MAY$_p$	n.a.	n.a.	38	74	230	15,838	149	9,265	36	2,622	45	3,951
1986 TOTAL	3,283	1,908	452	923	1,770	122,474	839	51,616	345	24,720	586	46,138
1985 TOTAL	2,194	902	251	1,041	1,261	83,305	338	19,784	192	13,046	731	50,475
5 MONTHS												
1987	n.a.	n.a.	211	316	1,051	66,495	629	38,996	218	16,036	203	17,462
1986	1,405	967	114	324	568	38,835	267	16,456	102	7,208	199	15,171
1985	824	316	84	424	467	30,116	113	6,400	65	4,228	289	19,488
1984	823	214	95	514	571	36,270	103	5,459	99	6,389	369	24,422

SECONDARY MARKET ACTIVITY

(Dollars in millions)

YEAR AND MONTH	FNMA Portfolio Comm.	FNMA Portfolio Purc.	FNMA Mortgage-Backed Securities Outstanding	FNMA Mortgage-Backed Securities Issued	FHLMC* Comm. to Sell	FHLMC* Comm. to Buy	FHLMC* Mtg. Purc.	FHLMC* Mtg. Sold	GNMA Pass-Through Securities Applications	GNMA Pass-Through Securities Issued
1986										
DEC	1,272	2,336	97,174	5,494	7,993	8,742	11,306	11,579	10,377	12,123
1987										
JAN	948	1,346	101,687	6,363	7,294	8,003	7,950	8,215	13,932	10,624
FEB	912	979	104,670	4,691	8,503	7,990	7,961	7,844	11,668	9,692
MAR	2,805	1,435	107,673	4,627	9,003	14,314	9,394	9,145	10,873	10,736
APR	3,208	2,118	112,673	6,997	n.a.	n.a.	n.a.	n.a.	15,050	11,934
MAY$_p$	1,726	1,718	116,861	7,086	n.a.	n.a.	n.a.	n.a.	10,220	3,515
1986 TOTAL	32,987	30,826	—	60,566	n.a.	n.a.	n.a.	n.a.	152,911	98,169
1985 TOTAL	20,225	19,848	—	23,649	44,085	46,762	44,012	44,085	64,360	45,868
5 MONTHS										
1987	9,599	7,595	—	29,764	24,800	30,307	23,305	25,204	61,743	46,501
1986	13,122	7,366	—	16,528	25,842	28,346	19,827	19,061	49,127	28,135
1985	8,825	8,975	—	6,680	14,644	15,480	10,877	9,498	20,814	14,279
1984	8,123	7,958	—	4,836	6,025	6,430	5,081	3,907	15,862	12,995

*Year-to-date totals are for three months only.

INTEREST RATES AND YIELDS

YEAR AND MONTH	1- to 4-UNIT MORTGAGES: FHA OPINION SURVEY FHA New[4]	FHA OPINION SURVEY CONVENTIONAL New	FHA OPINION SURVEY CONVENTIONAL Existing	FHLBB SURVEY CONVENTIONAL New	FHLBB SURVEY CONVENTIONAL Existing	FNMA 1 Yr. ARM (1%/Yr.)	FNMA FRM Conv.	APARTMENTS[5]
1987								
JAN	8.79%	9.09%	9.10%	9.51%	9.53%	8.31%	8.815%	10.81%
FEB	8.81	9.04	9.04	9.23	9.21	8.48	8.668	10.25
MAR	8.94	9.19	9.20	9.14	9.09	8.06	8.633	10.24
APR	10.02	10.11	10.14	9.21	9.09	8.35	9.655	12.08
MAY	10.61	10.44	10.46	9.37	9.27	8.85	10.208	12.65
JUN$_p$	n.a.	n.a.	n.a.	9.5	9.42	8.69	9.995	n.a.

YEAR AND MONTH	CURRENT SECONDARY MARKET YIELDS GNMA[6]	FNMA[6]	FHLMC[6]	SELECTED SECURITIES A-Rated[7] Utility	U.S. Government 10-yr.	U.S. Government 26-wk.	Prime Comm. Paper 90-119 Days
1987							
JAN	8.22%	8.31%	8.26%	8.92%	7.08%	5.44%	5.84%
FEB	8.06	8.21	8.17	8.82	7.25	5.59	6.05
MAR	8.12	8.25	8.22	8.84	7.25	5.59	6.16
APR	9.06	9.13	9.08	9.51	8.02	5.90	6.45
MAY	9.76	n.a.	n.a.	10.05	8.61	6.05	6.93
JUN	9.69	9.70	9.65	10.05	8.4	5.99	6.92

YEAR AND MONTH	SPREADS (Basis Points) FHA New Minus A-Utility	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
1987				
JAN	−13	114	123	118
FEB	−1	81	96	92
MAR	10	87	100	97
APR	51	104	111	106
MAY	56	115	n.a.	n.a.
DEC	n.a.	129	130	125

NA—Not available, p—Preliminary

[1] From the National Association of Realtors "Existing Home Sales" series

[2] Mutual Savings Banks and Commercial Banks

[3] FHA applications received includes the Direct Endorsement Program starting in 1984.

[4] Secondary market gross yields.

[5] Federal Home Loan Mortgage Corp. Existing Construction only.

[6] Securities for 0 to 30 day delivery.

[7] Prior to January 1984 this rate was for Aaa-rated New Issue Utility Bonds.

[8] Year-to-date seasonally adjusted series not calculated.

[9] 1985 data on mortgage bankers obtained from the HUD Survey of Mortgage Lending Activity.